HOW DO CORPORATE GOVERNANCE MECHANISMS AFFECT A FIRM’S POTENTIAL FOR BANKRUPTCNY?

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Abstract

The purpose of this thesis is to understand the effects of corporate governance mechanisms on the potential for bankruptcy. This study is done by utilizing the linear regression fixed effect vector decomposition model on 30 listed firms from the consumer goods sector of Indonesia Stock Exchange during the 2010-2012 periods. The results of the study indicate that: the board of commissioners’ independence and size of the commissioners’ board pose a significant positive effect on the potential for bankruptcy; the presence of an audit committee and the presence of a nomination and remuneration committee pose a significant negative effect and institutional ownership and managerial ownership do not significantly affect the potential for bankruptcy.

Keywords: Corporate Governance Mechanism, Bankruptcy, Altman Z-Score

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1. Introduction

Indonesia has been engulfed in a prolonged economic crisis since 1997. The impact of the 97-98 crisis over the economy could be observed in the abnormal increase in the country’s inflation rate which peaked at 77.6% by the end of 1998 (Riyanti, 2003). Around a decade after the 97-98 economic turmoil, Indonesia’s economy was taken aback when the pressure of oil subsidies finally cracked Indonesia’s balance of payment, which caused a substantial rise of oil prices on 2005. On 2008, Indonesia once again experienced turbulences in its economy caused by the subprime mortgage crisis which originated from the United States of America. Meanwhile, in the second half of 2013, Indonesia experienced yet another economic drawback when the failure of the foreign exchange policies precipitated the sudden increase of the Indonesian Rupiah – US Dollar exchange rate and the fluctuations of the Indonesia Stock Exchange Composite Index. According to Chatib Basri (referenced in Djumena, 2013), the Financial Minister of the Republic of Indonesia, these fluctuations could be an early warning for another impending economic crisis.

Based on the data from Indonesia’s central bank, Bank Indonesia (referenced in Pranowo, Achsani, Manurung, & Nuryantono, 2010), commercial banks experienced a substantial rise of non-performing loans when the economy experiences periods of distress. The magnitude of non-performing loans in Indonesia throughout these conditions is a common indicator that a large number of firms are financially distressed or in a high risk for bankruptcy (Adnan & Kurniasih, 2000). It can be concluded that Indonesia’s economic instability has triggered rampant firm bankruptcies within the country.

Indonesia’s fluctuating economic climate in the recent decade indicates that Indonesian investors have a critical need for a comprehensive model for predicting firm bankruptcies. Thus far, one of the most commonly used method for predicting bankruptcy is the Altman Z-Score. The formula that was discovered by Edward Altman (1968, referenced in Harrison, 2005) utilizes a number of systematically-weighted financial ratios to produce a certain score than can estimate the probability of firms going bankrupt in the near future. The success of the model could be observed from the results of Altman’s experiments which signified that the model possesses a relatively high predicting accuracy until two years prior to the event of bankruptcy (Altman, 1968, referenced in Diakomihalis, 2012). Other than for predicting bankruptcy, Hayes, Hodges, & Hughes (2010) stated that the scores produced by the method could also function as measurement of a firm’s health.

Even though the Altman Z-Score has proven its usefulness in predicting bankruptcy, the method only utilizes the firms’ financial and accounting data without taking the characteristics of the firms’ corporate governance mechanisms into account.
According to the findings of Chang (2009) and Fich & Slezak (2008), poor corporate governance practice and the failure of corporate governance mechanisms is a significant contributing factor on a number of firm bankruptcies in the past. Based on these findings, it can be concluded that although a certain firm’s financial conditions and financial performance play a vital role in avoiding bankruptcy, the firm’s governance mechanisms are also integral for the company’s ability to avoid bankruptcy. Consequently, even though the Altman Z-Score has proved to be highly accurate in predicting bankruptcy, it is also important for the scores produced by the model to reflect the state of the company’s governance mechanisms.

Corporate governance is basically a set of systems or mechanisms that governs a firm and can produce an added value for the firm’s stakeholders (Kaihatu, 2006). In accordance to the idea that some corporate governance structures may give more incentive for the management to respond better to financial distress (Fich & Slezak, 2008), the knowledge of the effects that corporate governance mechanisms have on a firm’s potential for bankruptcy can provide considerable benefits for the company’s stakeholders. The corporate governance mechanisms observed in the study are the ownership structure, the independence and size of the board of commissioners, the presence of an audit committee, and the presence of a nomination and remuneration committee.

The components of the ownership structure that will be observed are divided into two parts, consisting of institutional ownership and managerial ownership. Matos & Ferreira (2008) and Chen, Blenman, & Chen (2008) concluded that the presence of institutional investors, who tend to possess more experience and capital than individual investors, will warrant better performance and less cost of capital for the firm. However, Charfeddine & Elmarzougui (2010) claimed that institutional ownership will give a negative impact on the company’s performance. It is important to note that poorly-performing companies tend to have higher risk of bankruptcy.

The presence of managerial investors in a company should give an additional incentive for the company’s management to respond more quickly and swiftly towards the possibility of bankruptcy (Yermack, 1996, referenced in Fich & Slezak, 2008). The research that was done by Fich & Slezak (2008) supports the aforementioned statement, with the results which signify that managerial ownership poses a negative impact on a company’s potential for bankruptcy. Meanwhile, Chang (2009) found that managerial ownership does not have any significant effects on a company’s potential for bankruptcy.

An independent commissioner is a member of the board not affiliated with the controlling shareholders, directors, and/or the other commissioners of the company, and does not assume a director’s position in another company that is affiliated to said company. The independence of the board is the proportion of the independent commissioners compared to the total number of commissioners in the board. Baysinger & Butler (1985, referenced in Chang, 2009) observed that companies with good performance have a high degree of board independence. These findings are associated with the independent commissioners’ supposed tendency to give better transparency of a company’s financial performance (Osterland, 2004, referenced in Chang, 2009) and to give useful perspective for the company (Fich & Slezak, 2008). However, when conditioning for distress, the role of independent commissioners is still relatively unexplored (Bhagat & Black, 2005).

The studies done by Chang (2009) and Fich & Slezak (2008) found that the number of the commissioners in the board has a positive relationship with higher potential for bankruptcy. While a larger board is associated with a wider pool of ideas, a smaller board is believed to promote more effective monitoring and a more agile board that can respond better to financial distress (Chang, 2009).

Other corporate governance mechanisms that might be needed by the shareholders are the presence of subcommittee boards, such as an audit committee as well as a nomination and/or remuneration committee that operate separately from the board of directors and commissioners (Cadbury Committee, 1992). The audit committee is mainly responsible in aiding the board of commissioners in overseeing the external auditing process that is done on the firm and other monitoring-related issues. The presence of an audit committee enables better monitoring of the firm and increases the trustworthiness of the financial statements published. Some experts have observed the effects of the presence of an audit committee within a firm. Laing & Weir (1999) finds that the presence of an audit committee has a positive impact on a firm’s performance, while Malik (2012) did not find any significant correlation between the presence of an audit committee and a firm’s performance. Considering that Altman (1968, referenced in Diakomihalis, 2012) stated that the performance is one of the components of measuring distress, it is important to look further into these findings when a model for financial distress is conditioned.

The nomination and remuneration committee is responsible for nominating new candidates for the board of commissioners and/or directors at the end of each term and recommending the amount of the directors’ and/or commissioners’ remuneration for each period (Cadbury Committee, 1992). It is imperative for these two committees to make their decisions independently so they can formulate a nomination and remuneration plan that can motivate the board and protect the interests of the shareholders. Dalton, Daily, Ellestrand, & Johnson (1998) stated that the studies on the effects of the presence of a nomination and remuneration committee are
relatively uncommon. However, Klein (1998) concluded in his study that there is a positive correlation between the presence of a nomination and remuneration committee and the company’s performance.

Although a large number of studies on the potential for bankruptcy has been done on stock markets in developed countries, studies that observe the potential for bankruptcy in developing countries’ stock markets is still relatively few and far in between (Pranowo et al., 2010). Subsequently, the Indonesian consumer goods sector has consistently given the largest contribution among all other manufacturing sectors to Indonesia’s annual Gross Domestic Product (Kementerian Perindustrian Republik Indonesia, 2013). Considering the aforementioned factors in this paragraph, this study attempts to understand the influence that corporate governance mechanisms pose on a firm’s potential for bankruptcy.

2. Theoretical Basis and Hypotheses

The Indonesian Government Regulation Substituting for Act number 1 of 1998 on the Amendment of Bankruptcy Act (Peraturan Pemerintah pengganti UU No. 1 tahun 1998 tentang Perubahan atas UU Kepailitan) states that bankruptcy occurs when a debtor that has two or more creditors defaults in paying at least one liability past its maturity and declared bankrupt by the authorized court rule, either under the debtor’s own request or at least one of its creditors’ request. Before a certain firm declares bankruptcy, it usually undergoes a certain period of degradation called financial distress (Platt & Platt, 2002). Toto (2011) explained that bankruptcy does not happen instantaneously, because there appears to be certain early indications of distress that can be recognized if the firm’s financial statements are analyzed thoroughly.

On 1968, Edward Altman, a professor from New York University introduced the Z-Score model that can supposedly predict bankruptcy. For four decades, his model has become a widely accepted prediction model for bankruptcy (Calandro, 2007). According to Hanafi & Halim (2009), Altman utilized a particular statistical technique, the discriminant analysis, to develop a model that can calculate a firm’s risk of going bankrupt.

The definition of good corporate governance that is stated by the Indonesian Ministerial Decree for Government-Owned Companies KEP-117/M-MBU/2002 (Keputusan Menteri Badan Usaha Milik Negara Nomor: KEP-117/M-MBU/2002) is governance as a process or a structure that can be utilized by firms to increase its operational success and its accountability in order to realize long-term shareholder value while still regarding the interests of other stakeholders and be in accordance with government regulations and ethical values. Meanwhile, Rezaee (2007) stated that corporate governance is a certain mechanism that functions as a synchronizer of the management’s interests with the shareholder’s interests in order to reduce agency costs and create long-term value for shareholders. Dharmastuti & Wahyudi, 2013; Malik, 2012; Fich & Slezak, 2008; Chang, 2009 stated that the presence of various corporate governance mechanisms may increase the degree of shareholders’ monitoring towards the management and prove to be beneficial for firms.

Minow, Monks, & Robert (2011), stated that the ownership structure of a firm reflects the characteristics of the shareholders or investors of the firm related to their influence within the company. The types of investors included in the ownership structure of a company can be divided into two categories: individual investors and institutional investors. Managerial ownership is a form of individual ownership that can act as a governance mechanism, while the institutional ownership is also said to influence the governance structure of a firm (Fich & Slezak, 2008).

David, Kochhar, & Levitas (1998) & Minow et al. (2011) defined institutional ownership as the portion of stocks that is owned by any organizational or corporate institution. Guo & Ni (2008, referenced in Dharmastuti & Wahyudi, 2013) remarked that institutional investors have a very important role in corporate governance, especially in its ability for monitoring, information-gathering, and its impact towards company policies and performance. Chen et al. (2008) claimed that there are three benefits from institutional ownership; specifically the higher economic profit as an effect of ownership cost efficiency, the reduction of costs in coordinating the management, and ownership stability as an effect of the difficulties in selling large quantities of stocks that are usually owned by institutional owners. These characteristics might provide more effective monitoring for firms in periods of distress, thus the following hypothesis could be formulated

\[ H1: \text{Institutional ownership has a negative effect on potential for bankruptcy.} \]

Gideon & Boediono (2005) defined managerial ownership as the amount of stocks owned by the management of the firm out of the total of the firm’s outstanding stocks. Managerial ownership is one of the solutions for the agency problem, because studies have found that the increase in the amount of managerial ownership will increase the incentive for the management to satisfy the shareholder’s interests (Jensen & Meckling, 1976; Fich & Slezak, 2008). Therefore, the conclusion that managerial ownership may increase a distressed firm’s performance can be reached, and the following hypothesis could be formulated:

\[ H2: \text{Managerial ownership has a negative effect on potential for bankruptcy.} \]

The Ministry for Government-Owned Firms Regulations number PER-01/MBU/2011 article 12
financial information before it is published; (2) evaluating the independence and objectivity of the firm’s public accountants, the adequacy of the inquiry done by the public accountants, the effectiveness of the firm’s internal control, and the degree of the firm’s obedience to regulations; (3) examining the possibility of mistakes in the director’s decisions or the digression in the execution of said decision. The important role of audit committees is theorized to eventually provide better protection for the shareholders’ interests (Laing & Weir, 1999). Therefore, the following hypothesis could be formulated:

H5: The presence of an audit committee has a negative effect on potential for bankruptcy

Murwaningsari (2009) explained that a nomination committee is a group of people employed to help the commissioners in selecting new candidates for the board of commissioners and directors. The main function of the nomination committee is to give recommendations to the board of commissioners about the following issues: (1) procuring the list of director-nominees and commissioner-nominees that are going to be selected by the shareholders; (2) selecting the commissioners that will work in a committee that is responsible in recommending new directors or commissioners to the shareholders.

Meanwhile, Murwaningsari (2009) defined the remuneration committee as a committee that consists of professional members from outside the firm as a part of the executive compensation system and tasked with helping the board in deciding the compensation package for the top executives that will be suggested to the shareholders. The main functions of the remuneration committee according to Government-Owned Companies’ Advisory Board (Badan Pembina BUMN, 1999) are: (1) evaluating and recommending changes in the remuneration system of directors, commissioners, and employees to reflect the relationship between reaching the firm’s performance goals with the level of reward or punishment; (2) evaluating and recommending changes on the distribution and usage of the facilities provided for the directors, commissioners, and employees to prevent misappropriations; (3) reporting the results of the evaluations and the recommendations to the shareholder’s meeting for approval. The presence of a remuneration committee that mainly consists of members from outside of the company will create more pressure for the board of directors and commissioners to provide a higher level of performance in order to get the appropriate remuneration by the end of each period (Sheridan, 1993). Previous studies done on the effects of nomination and remuneration committees found that these committees could make firms perform better (Malik, 2012; Sheridan, 1993; Laing & Weir, 1999).

The last hypothesis of this study could be formulated based on the literature studies that have been conducted:
**H6:** The presence of a nomination and remuneration committee has a negative effect on potential for bankruptcy.

To summarize, this study tests the hypotheses for the model presented in Figure 1 below. In developing the conceptual model, this study discusses a number of selected governance mechanisms that may influence a firm’s potential for bankruptcy.

![Figure 1. Illustration of the Conceptual Framework](image)

### 3. Research Method

This study observes all listed firms from the consumer goods sector in Indonesia Stock Exchange (IDX) throughout 2010-2012. All financial data are obtained from the annual publications from www.idx.co.id. In total, 36 listed firms operate within...
the observed sector, but 6 are excluded from the population because of the following factors:

1. The excluded firms have not published their complete audited financial reports or annual reports ending on December the 31st within the observed time period;
2. The excluded firms have not done an initial public offering (IPO) before the end of the first year of the observation period.

Therefore, the number of research objects observed amount to 30 firms over a period of 3 years, which makes a total of 90 observations.

The following table describes the details on the operational definition of each variable:

<table>
<thead>
<tr>
<th>Independent Variables</th>
<th>Operational Definition</th>
</tr>
</thead>
<tbody>
<tr>
<td>INS_OWN</td>
<td>The proportion of institutional ownership within the firm</td>
</tr>
<tr>
<td>MAN_OWN</td>
<td>The proportion of shares owned by directors and commissioners</td>
</tr>
<tr>
<td>INDEP</td>
<td>The proportion of independent commissioners within the board</td>
</tr>
<tr>
<td>BOARDSIZE</td>
<td>The number of commissioners employed within the firm</td>
</tr>
<tr>
<td>AUD</td>
<td>A variable which will be given a value of 1 if an audit committee is present within a firm and 0 if it is not</td>
</tr>
<tr>
<td>RN</td>
<td>A variable which will be given a value of 1 if a nomination and remuneration committee is present within a firm and 0 if it is not</td>
</tr>
</tbody>
</table>

The data analysis method of this study is done by utilizing multiple linear regression on the panel data. The Chow and Hausman tests are carried out to decide the best panel data estimation method between the pooled, fixed effect, and random effect model (Gujarati, 2003). If the fixed effect model is deemed the most appropriate estimation method, the observation of time-invariant variables within the study (the presence of both committees) will create a singularity which will deem the fixed effect estimation mathematically impossible. In order to counteract the problem, this study will utilize the fixed effect vector decomposition (FEVD) model proposed by Plumper & Troeger (2004) to estimate the fixed effects with time-invariant variables. Other than that, a series of classical assumption tests are also undertaken in order to ensure that the estimated parameters are the best linear unbiased estimators (BLUE) (Ghozali, 2011).

The study utilized the six governance mechanisms as the independent variables and the Altman Z-Score as the dependent variable to estimate the following regression:

\[ Z = \alpha + \beta_1 \text{INS}_\text{OWN} + \beta_2 \text{MAN}_\text{OWN} + \beta_3 \text{INDEP} + \beta_4 \text{BOARDSIZE} + \beta_5 \text{AUD} + \beta_6 \text{RN} \]

Where \( \alpha \) is the intercept of the equation, and \( \beta_1-\beta_6 \) signifies the coefficient of each independent variable. Meanwhile, \( Z \) is dependent variable in the equation, which is the Altman Z-Score, and \( \text{INS}_\text{OWN}, \text{MAN}_\text{OWN}, \text{INDEP}, \text{BOARDSIZE}, \text{AUD}, \text{RN} \) represents the governance mechanisms as the independent variables.

4. Research Results And Discussions

The descriptive statistics of the observation are indicated on the following table:

<table>
<thead>
<tr>
<th>N</th>
<th>Valid</th>
<th>Z</th>
<th>INS_OWN</th>
<th>MAN_OWN</th>
<th>INDEP</th>
<th>BOARDSIZE</th>
</tr>
</thead>
<tbody>
<tr>
<td>90</td>
<td></td>
<td>5.3700</td>
<td>0.7699</td>
<td>0.0166</td>
<td>0.4230</td>
<td>4.2555</td>
</tr>
<tr>
<td>Mean</td>
<td>Mode</td>
<td>Minimum</td>
<td>Maximum</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>3.8900</td>
<td>0.8500</td>
<td>-1.0800</td>
<td>20.3400</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>0.3307</td>
<td>0.2308</td>
<td>0.8000</td>
<td>10.0000</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
The dependent variable of the study, which is the potential for bankruptcy measured by the Altman Z-Score (Z). It has an average value of 5.37 and a mode of 3.89, which indicates that most consumer goods firms are in a healthy state. This conclusion could be claimed considering the thresholds of the Z-Score which indicates that a value of more than 2.99 means that a firm is safe from the probability of going bankrupt (Calandro, 2007). The average percentage of institutional ownership has a relatively high value of 76.99%, with a mode of 85%. This signifies that institutional investors are dominating the ownership of consumer goods firms. The percentage of managerial ownership (MAN_OWN) is indicated that the average value of managerial ownership is 1.66% with a mode of 0%. In fact, the number of observations that reported 0% managerial ownership amount to 56 observations out of the total of 90 observation units. It can be concluded that managerial ownership as a governance mechanism is not commonly applied in consumer goods firms.

The commissioners’ independence (INDEP) measured by the proportion of independent commissioners in the board shows a range of values between 30% and 80%. This implies that all firms in the consumer goods sector have complied with the regulations that were ratified in the Jakarta Stock Exchange Ltd. Directorial Decree number KEP-305/BEJ/07-2004 which stated that at least 30% of the members of the commissioners’ board should consist of independent commissioners. The average size for the commissioners’ board (BOARDSIZE) is 4.26 with a mode of 3 people. This shows that consumer goods firms tend to employ a relatively small board with less than 5 people. The result implies that the companies prefer agility in responding to change than a wider pool of ideas in the commissioners’ board.

This study observes two independent dummy variables is given a value of 0 if the firm does not have a committee and a value of 1 if the firm does.

<table>
<thead>
<tr>
<th>Table 3. Frequency Distribution of the Presence of Committees</th>
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<tbody>
<tr>
<td><strong>Audit Committee</strong></td>
</tr>
<tr>
<td>Frequency</td>
</tr>
<tr>
<td>Valid</td>
</tr>
<tr>
<td>1.0000</td>
</tr>
<tr>
<td>Total</td>
</tr>
</tbody>
</table>

The table indicates that 87 out of the total 90 observations were given a value of 1 for this dummy variable. This means that nearly 97% of consumer goods firms have adhered to the Head of Monitoring Body for Capital Market and Financial Institutions Decree number Kep.29/PM/2004 which states that all listed firms are required to have an audit committee.

The value nomination and remuneration committee of 0 was given to 63 observations out of the total 90 observations, which indicates that a substantial number of consumer goods firms do not employ a nomination and remuneration committee.

Based on the results of the Chow and Hausman tests, the fixed effects model is chosen as the most appropriate panel data estimation method. The presence of time-invariant variables within the observation means that an ordinary fixed effect model could not be estimated, which means that the fixed effect vector decomposition (FEVD) model will be utilized in order to estimate fixed effects with time-invariant variables.

<table>
<thead>
<tr>
<th>Table 4. Summary of the FEVD Model Regression Analysis</th>
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<tbody>
<tr>
<td><strong>Variables</strong></td>
</tr>
<tr>
<td>INS_OWN</td>
</tr>
<tr>
<td>MAN_OWN</td>
</tr>
<tr>
<td>INDEP</td>
</tr>
<tr>
<td>BOARDSIZE</td>
</tr>
<tr>
<td>AUD</td>
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<tr>
<td>NR</td>
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<tr>
<td>ERROR_S2</td>
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</tbody>
</table>
The estimated model has been tested for multicollinearity by utilizing the Variance Inflation Factor, serial autocorrelation by utilizing the Durbin-Watson test, and heteroskedasticity by utilizing the Glejser test. It was found that the model passed all classical assumption tests, thus it can be ascertained that the estimators of the model is the best linear unbiased estimators (BLUE).

The goodness-of-fit tests indicate an adjusted R2 value of 0.8622, which means that 86.22% of the variations in the dependent variable could be explained by the variables within the model. The probability value of the F-statistic is 0.0000, which is less than the designated significance level of 5%. This signifies that the independent variables within the model simultaneously affect the dependent variable.

The findings in this thesis will be discussed with regards to the initial hypotheses that have been formulated.

1. The initial hypothesis is not supported by the findings which indicate that institutional ownership does not significantly affect the potential for bankruptcy. This result coincides with the studies done by Fich & Slezak (2008) and Lowenstein (1991) which concluded that institutional ownership does not have any significant effect on a firm’s potential for bankruptcy. However, the result of this study does not correspond with the studies done by Murwaningsari (2009) and Dharmastuti & Wahyudi (2013), which stated that institutional ownership poses a significant positive effect on firm performance, one of the indicators of bankruptcy potential.

A number of speculations have been formulated about the reasons why this result is found on Indonesian companies. Bathala, Moon, & Rao (1994, referenced in Charfeddine & Elmarzougui, 2010) argues that institutional investors in some countries do not prefer to be directly involved in corporate decision making; they prefer using an exit policy which signifies that they would rather sell their shares when they are dissatisfied with the management. Their statement was backed by Seifert, Gonenc, & Wright (2005) who found inconsistent results in measuring the influence of institutional investors in companies from different countries and concluded that the nature of institutional investors are location-specific. Based on these findings, it is presumed that Indonesian institutional investors are not as active as expected in the management of firms. This is sometimes caused by the fact that most institutional investors are index funds that are more concerned in attaining high returns for the index fund holders than making the company perform well (Fich & Slezak, 2008).

2. This hypothesis is not supported; the estimated model in this study indicates that managerial ownership does not significantly affect the potential for bankruptcy. This finding is parallel to the results of a number of studies (Chang 2009; Jahmani & Ansari, 2006; Pederson & Thomsen, 1999) which affirmed that managerial ownership does not pose any significant influence on a number of measures for firm health. On the other hand, this finding does not conform to the findings of Fich & Slezak (2008) which reveals that managerial ownership negatively affects the potential for bankruptcy.

It is speculated that one of the reasons for the insignificance of this variable on the potential for bankruptcy is caused by the exigency in the use of managerial ownership as a corporate governance mechanism in Indonesia. This statement is supported from the result of the descriptive statistics which reveals that 56 out of 90 observations have 0% managerial ownership. Meanwhile, Jahmani & Ansari (2006) affirmed that managerial ownership only gives the shareholders an increased expectation that the management will work for the shareholders’ interests. However, it is further explained that managerial ownership might provide benefits for the managers through dividends and stock capital gains, thus reducing the incentives from performance-based compensations. Therefore, Jahmani & Ansari claimed that managerial ownership does significantly affect firm performance, and might even give a negative effect on firm performance.

3. The results of this study signifies that the commissioners’ board independence pose a significant positive effect on the potential for bankruptcy. This finding contradicts the initial hypothesis which states that commissioners’ independence pose a negative effect on the potential for bankruptcy. In spite of the dissimilarity of this finding with the findings of previous studies (Chang, 2009; Fich & Slezak, 2008; Jaikengkit, 2004; Cotter, Shvidasani, Zenner, 1997) which claim that independent commissioners affects the performance or value of the company positively, a number of experts have formulated the rationale of why sometimes independent commissioners could increase a firm’s probability for falling into financial distress.

Fich & Slezak (2008) stated that although independent commissioners enable better monitoring, when financial distress is factored in the study, non-independent commissioners might have a larger incentive to overcome financial distress because the higher risk for them being laid off in the event of bankruptcy. Bhagat & Black (2002) and Ritchie (2007) revealed that the degree of involvement associated with non-independent commissioners gives them deeper knowledge, experience, and expertise on the management and goals of the firms.
they work for compared to independent commissioners. Erickson, Park, Reising, & Shin (2005) found some evidence of reverse causality between board independence and firm performance, which means that firms that perform poorly might try to employ more independent commissioners to appease investors.

It is speculated that independent commissioners enable better monitoring until a certain number of them have been employed. After the certain number is met, the addition of independent commissioners could actually pose a negative influence on the firm. This statement supports the findings of Block (1996).

4. The result of this study support the initial hypothesis with findings that signify the commissioners’ board size poses a significant positive effect on the potential for bankruptcy. This result conforms to the study of Mak & Kusnadi (2005), Eisenberg, Sundgren, & Wells (1998), Fich & Slezak (2008), and Chang (2009) which revealed that commissioners’ board size positively affects the potential for bankruptcy. In accordance with Chang (2009), firms tend to benefit from a more flexible board that can respond quickly to change in periods of distress. Fich & Slezak (2008) also found that a smaller board provides more effective monitoring which is invaluable in times of financial distress.

5. It has been found that the presence of an audit committee pose a significant negative effect on the potential for bankruptcy. This confirms the initial hypothesis of the study about the presence of audit committee. The result of this study coincides with the findings of Laing & Weir (1999), but does not coincide with the findings of Malik (2012) which states that the presence of audit committee does not significantly affect the potential for bankruptcy. Based on the findings of this study, it can be concluded that audit committees have an important monitoring role for firms and for protecting the shareholders’ interests, especially in periods of distress.

6. The prior hypothesis of this study which states that the presence of nomination and remuneration committee pose a significant negative effect on the potential for bankruptcy is supported by the findings of this study. This result goes in accordance with the Cadburry Committee (1992) statement which claimed that the nomination and remuneration process of the board needs to be done independently in order to maximize firm value and protect the shareholders’ interests. This result also coincides with the findings of Malik (2012) and Laing & Weir (1999) which revealed that the presence of nomination and remuneration committee pose a significant positive effect for one of the components of bankruptcy potential measurement, firm performance.

Although studies that observe the effects of the nomination and remuneration committees are relatively uncommon (Dalton et al., 1998), the presence of this committee might provide an incentive for the board of directors and commissioners to manage the company well (Sheridan, 1993). Based on the findings of this study, it can be concluded that the presence of a nomination and remuneration committee might provide additional pressure for the management and employees to perform well in order to maintain their positions and attain the desired amount of remuneration.

5. Conclusion and Suggestions

This study utilizes multiple linear regressions with the fixed effect vector decomposition (FEVD) model as the panel data estimation method to understand the effects of corporate governance mechanisms on the potential for bankruptcy of listed consumer goods companies from the Indonesia Stock Exchange throughout the 2010-2012 periods. Based on the findings of this study, it can be concluded that institutional ownership and managerial ownership does not significantly affect the potential for bankruptcy. Meanwhile, the independence of the board of commissioners is found to pose a significant positive effect the potential for bankruptcy. It is presumed that Indonesian companies might employ independent commissioners in order to meet regulations while ignoring their knowledge, experience, and expertise on the firms. Other than that, poorly-performing firms might hire more independent commissioners to appease investors in order to protect their source of capital.

The findings of this study signify that firms that employ a smaller board, an audit committee, and a nomination and remuneration committee are less likely to go bankrupt. These mechanisms provide the company with flexibility in responding to change, more effective monitoring, and more incentive for the management to make the company perform better.

This study implies that investors need to take corporate governance mechanisms into account in considering investment decisions. These are some governance characteristics of Indonesian firms that need to be considered: (1) small commissioners’ board size, an audit committee, and a nomination and remuneration committee employed within the firm implies less potential for bankruptcy; (2) high degree of board independence does not warrant a safer investment.

References:


